

## **Private Equity: Economic Savior or Scourge?**

Testimony before the Subcommittee on Telecommunications and the Internet  
Committee on Energy and Commerce  
U.S. House of Representatives

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March 11, 2008

Thank you for the invitation to testify today.

In the past decades, the private equity industry has grown both in terms of size and geographic reach. In markets as diverse as China, Germany, South Korea, the United Kingdom, and the United States, this growth has triggered anxiety about the impact of private equity on employment, managerial time-horizons, the overall health of companies and the economy more generally.

This anxiety is not unreasonable. While the leveraged buyout transactions of the 1980s were scrutinized in a number of important academic analyses, these studies had two important limitations. First, the bulk of the older research focused on a relatively small number of transactions involving previously publicly traded firms based in the United States. But these represent only a very modest fraction of all buyouts. The second limitation of the older research relates to the fact that the industry has grown and evolved tremendously since the 1980s.

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The World Economic Forum's research project on "The Global Economic Impact of Private Equity," which I led, sought to address this problem. The goal was to complete a rigorous study of the impact of these investments around the world, prepared by a team of leading international scholars, including Ann-Kristin Achleitner, Francesca Cornelli, Lily Fang, Roger Leeds, and Per Stromberg, as well as a number of co-authors, and guided by a steering committee that included leaders from the private equity industry, pension funds, organized labor, and the public sector.

Our study involved a broad array of research on private equity's economic impact. In this testimony, I highlight six conclusions that we as authors found particularly interesting.

The first study examined the nature and outcome of the 21,397 private equity transactions world-wide between 1970 and 2007. The key findings were:

- 6% of buyout transactions end in bankruptcy or financial restructuring. This translates into an annual rate of bankruptcy or major financial distress of 1.2% percent per year. This rate is lower default rate for U.S. corporate bond issuers, which has averaged 1.6% per year.
- Holding periods for private equity investments have increased, rather than decreased, over the years. 58% of the private equity funds' investments are exited more than five years after the initial transaction. So-called "quick flips" (i.e. exits within two years of investment by private equity fund) account for 12% of deals and have also decreased in the last few years.

The second study examined long-run investments by firms. It was motivated by the lively debate about the impact of private equity investors on the time horizons of the

companies in their portfolios. The private status, according to some, enables managers to proceed with challenging restructurings without the pressure of catering to the market's demands for steadily growing quarterly profits, which can lead to firms focusing on short-run investments. Others have questioned whether private equity-backed firms take a longer-run perspective than their public peers, pointing to practices such as special dividends to equity investors.

In this study, one form of long-run investment was examined: investments in innovation. Innovation offers an attractive testing ground for the issues delineated above due to various factors. These factors include the long-run nature of R&D expenditures, their importance to the ultimate health of firms and the extensive body of work in the economics literature that has documented that the characteristics of patents can be used to assess the nature of both publicly and privately held firms' technological innovations.

The key finding was that:

- Patenting levels before and after buyouts are largely unchanged. But firms that undergo a buyout pursue more economically important innovations, as measured by patent citations, in the years after private equity investments. In a baseline analysis, the increase in the key proxy for economic importance is 25%. This results from firms focusing on and improving their research in their technologies where the firms have historically focused.

A third study examined the impact of private equity on employment. This question has aroused considerable controversy. Critics have claimed huge job losses, while private equity associations and other groups have released several recent studies that claim positive effects of private equity on employment. While efforts to bring data to the issue are highly

welcome, many of the prior studies have significant limitations, such as the reliance on surveys with incomplete responses, an inability to control for employment changes in comparable firms, the failure to distinguish cleanly between employment changes at firms backed by venture capital and firms backed by other forms of private equity, and an inability to determine in which nation jobs are being created and destroyed.

We constructed and analyzed a dataset in order to overcome these limitations and, at the same time, encompass a much larger set of employers and private equity transactions from 1980 to 2005. The study utilizes the Longitudinal Business Database (LBD) at the U.S. Bureau of the Census to follow employment at virtually all private equity-backed companies, before and after private equity transactions. We examine 300,000 U.S. establishments (specific factories, offices, and retail outlets where business takes place) that are part of 5,000 firms that received private equity investments, as well as 6 million matching establishments.

Among the key results were:

- Employment grows more slowly at establishments that are bought out than at the control group in the year of the private equity transaction and in the two preceding years. The average cumulative employment difference in the two years before the transaction is about 4% in favor of controls.
- Employment declines more rapidly in bought-out establishments than in control establishments in the wake of private equity transactions. The average cumulative two-year employment difference is 7% in favor of controls. In the fourth and fifth years after the transaction, employment at private equity-backed firms mirrors that of the control group.

- But firms backed by private equity have 6% more greenfield job creation, that is, at new facilities in the United States, than the peer group. It appears that the job losses at bought-out establishments in the wake of private equity transactions are largely offset by substantially larger job gains in the form of greenfield job creation by these firms.

The project has important implications for how to think about the role that private equity plays in the economy. To the authors, a few broader (albeit tentative) observations emerge from the works:

- The discussion of many aspects of private equity's impact on the economy has been characterized by confusion along many dimensions. As the employment study highlights, the evidence supports neither the apocalyptic claims of extensive job destruction nor arguments that private equity funds create huge amounts of domestic employment.
- The substantial periods that firms remain under private equity control and the robust long-run investments in innovation as measured by patents appear consistent with the view that the LBO organizational form is a long-run governance structure for many firms.
- The results regarding private equity's impact on employment – as well as those in the innovation study – fit the view that private equity groups act as catalysts for change in the economy.

More work remains to be done. There is clearly a need for further research that addresses additional questions such as the implications of private equity on productivity, wages, and unionization, as well as that understanding patterns outside the U.S. We intend to pursue these questions in follow-on work. Thank you for your attention.

More information on the project, including the full report, is available at [http://www.weforum.org/en/media/Latest%20Press%20Releases/PrivateEquity\\_PressRelease](http://www.weforum.org/en/media/Latest%20Press%20Releases/PrivateEquity_PressRelease)

## **Appendix: Summary of Josh Lerner's Testimony**

The growth of the private equity industry has triggered anxiety about its economic impact. The World Economic Forum's research project on "The Global Economic Impact of Private Equity," which I led, undertook a rigorous study of the impact of buy-out investments around the world, prepared by a team of leading international scholars, and guided by a steering committee that included leaders from the private equity industry, pension funds, organized labor, and the public sector.

Among the key findings were:

- The annual rate of bankruptcy or major financial distress of buyout is 1.2% percent per year, less than the lower default rate for U.S. corporate bond issuers (1.6%).
- Holding periods for private equity investments have increased, rather than decreased, over the years.
- Firms that undergo a buyout pursue more economically important innovations in the years after private equity investments.
- Employment grows more slowly at establishments that are bought out than at the control group in the year of the private equity transaction and in the two preceding years.
- Employment declines more rapidly in bought-out establishments than in control establishments in the wake of private equity transactions, a difference of 7% in the two years after the transaction.
- Firms backed by private equity have 6% more job creation at new facilities in the United States, than their peers. Job losses at bought-out establishments in the wake of private equity transactions are largely offset by substantially larger job gains in new facilities.

## Appendix II: Biographical Summary

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Josh Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and the Entrepreneurial Management Areas. He graduated from Yale College with a Special Divisional Major that combined physics with the history of technology. He worked for several years on issues concerning technological innovation and public policy, at the Brookings Institution, for a public-private task force in Chicago, and on Capitol Hill. He then earned a Ph.D. from Harvard's Economics Department.

Much of his research focuses on the structure and role of venture capital and private equity organizations. (This research is collected in two books, *The Venture Capital Cycle* and *The Money of Invention*.) He also examines policies towards intellectual property protection, particularly patents, and how they impact firm strategies in high-technology industries. (The research is discussed in the *Innovation and Its Discontents*.) He founded, raised funding for, and organizes two groups at the National Bureau of Economic Research: Entrepreneurship and Innovation Policy and the Economy. He is a member of a number of other NBER groups and serves as co-editor of their publication, *Innovation Policy and the Economy*.

In the 1993-94 academic year, he introduced an elective course for second-year MBAs on private equity finance. In recent years, "Venture Capital and Private Equity" has consistently been one of the largest elective courses at Harvard Business School. The course materials are collected in *Venture Capital and Private Equity: A Casebook*, now in its fourth edition. He also teaches a doctoral course on entrepreneurship and organizes an annual executive course on private equity.